Internal Revenue Service

memorandum

CC:TL-N-6602-89
Br2:LSMannix

date: MAY 26 1989

to: District Counsel, Chicago CC:CHI
Attn: Joseph Ferrick

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: Technical Assistance - Treas. Reg. § 1.1092(b)-3(T) Election: [redacted] v. Commissioner, Docket No. [redacted]

This responds to your request for tax litigation advice dated May 5, 1989 and confirms our May 19, 1989 telephone conversation with Joseph Ferrick, in which we gave him our recommendation. This case is scheduled for trial on [redacted].

ISSUE

Whether the petitioner is permitted to identify (after petitioning the Tax Court) mixed straddles, that were established before February 25, 1985, in order to claim the preferred treatment of Treas. Reg. § 1.1092(b)-3T.

CONCLUSION

Because there is no statutory provision stating when a mixed straddle must be identified and Treas. Reg. § 1.1092(b)-3T is so ambiguous as to the time for identification, we recommend that this issue be conceded.

FACTS

The petitioner is a [redacted] in a designated group of stock options on the Chicago Board Options Exchange. In [redacted], he held positions in stock and options in the same stock.

On his [redacted] tax return, the petitioner treated the gains and losses from the stock as if they were unrelated to the gains and losses from the options. The petitioner treated the options as section 1256 contracts and reported the gain from the options trading as 40% short-term capital gain and 60% long-term capital gain. The petitioner apparently netted capital gains and losses from the stock trading, which resulted in a net short-term capital loss in excess of the net long-term capital gain. He reported this amount as a net short-term capital loss.

Upon examination, the Commissioner determined that the petitioner's positions in the stock and options were, in fact, mixed straddles as defined in section 1256(d)(4).1/ He, therefore, applied what is commonly referred to as the "killer rule." Treas. Reg. § 1.1092(b)-2T(b)(2). Under the killer rule, the Commissioner treated the losses from the stock as 60% long-term capital loss and 40% short-term capital loss. The Commissioner also treated the gain from the stock as short-term capital gain.

The notice of deficiency, based on the adjustments described above, was issued [redacted]. According to the notice, the petitioner owed an additional $[redacted] in tax. The petitioner filed his petition with the Tax Court on [redacted]

The petitioner is now attempting to avail himself of Treas. Reg. § 1.1092(b)-3T, which permits a special netting of gains and losses from mixed straddles. If the petitioner is permitted, at this late date, to make an election to have Treas. Reg. § 1.1092(b)-3T apply, he would be liable for additional tax but not nearly as much tax as the Commissioner determined under the killer rule.

DISCUSSION

The Tax Reform Act of 1984 expanded the scope of section 1092 to exchange traded stock options and expanded the scope of section 1256 to stock options traded by options dealers. Tax Reform Act of 1984, §§ 101(a)(1), (b)(1) and (2) and § 102(a)(2), 1984-3 (Vol. 1) C.B. 2, 124, 126, 128.

The Tax Reform Act of 1984 also added a new section 1092(b) which stated that the Secretary will prescribe regulations for the treatment of mixed straddles. Tax Reform Act of 1984, § 103(a), 1984-3 (Vol. 1) C.B. at 135. The new section 1092(b) states, among other things, that the regulations will prescribe how a "taxpayer may offset gains and losses from positions which are part of mixed straddles ... by straddle-by-straddle identification...." Although the Tax Reform Act of 1984 was enacted on July 18, 1984, it became effective for options transactions entered into after December 31, 1983. Tax Reform

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1/ A mixed straddle is straddle where at least one, but not all, the positions are section 1256 contracts. After 1983, the term "section 1256 contract" includes options traded by options dealers. Thus, the petitioner's straddles, where he held a position in a stock and an offsetting position in an option on the same stock, was a mixed straddle.

Act of 1984, §§ 101(e), 102(g)(2), 1984-3 (Vol. 1) C.B. at 127, 133. (Technically, an options' dealer had to make an election, under section 102(g)(2), in order to apply section 1256 to options traded in 1984. The petitioner made such an election.)

For taxable years starting after 1983, section 1092(a) states that a loss from one leg of a stock options straddle can only be recognized to the extent the loss exceeds the unrecognized gain on offsetting positions. Section 1256(a) requires stock options dealers to mark to market any options positions still open at the end of the taxable year. The gain or loss from each options contract will be treated as 40% short-term capital gain or loss and 60% long-term gain or loss.

The regulations mandated by section 1092(b) were published January 18, 1985. One of the regulations published on the authority of section 1092(b), Treas. Reg. § 1.1092(b)-3T, allows a taxpayer to net the gains and losses from offsetting straddle positions. This is preferable to the application of the killer rule, Treas. Reg. § 1.1092(b)-2T(b)(2), which, as stated above, treats any losses on the stock positions as a 40% short-term capital loss and a 60% long-term capital loss.

Under Treas. Reg. § 1.1092(b)-3T(d)(1), in order to take advantage of this special treatment, a taxpayer has to identify each mixed straddle, "on a reasonable and consistently applied economic basis," before the close of the day the straddle is established. Like the amended sections 1092 and 1256, Treas. Reg. § 1.1092(b)-3T applies to straddles established after 1983.

Because the regulations under section 1092(b) were not published until 1985, a taxpayer trading mixed straddles in 1984 could not have known of its requirements. Thus, Treas. Reg. § 1.1092(b)-3T(d)(5) contains an exception to the identification requirement. It states:

> Notwithstanding the provisions of paragraph (d)(1) of this section, relating to the time of identification of a section 1092(b)(2) identified mixed straddle, a taxpayer may identify straddles that were established before February 25, 1985, as section 1092(b)(2) identified mixed straddles after the time specified in paragraph (d)(1) of this section if the taxpayer adopts a reasonable and consistent economic basis for identifying the positions of such straddles.

In other words, Treas. Reg. § 1.1092(b)-3T(d)(5) states that for straddles established in 1984, the taxpayer does not have to identify the straddles before the close of the day the straddles are established. No other guidance or requirements as to identifying mixed straddles or electing the treatment of Treas. Reg. § 1.1092(b)-3T are prescribed in any Code section, regulation or published ruling. Put simply, for mixed straddles established in 1984, there is no deadline for identifying the straddles or deadline for electing the treatment of Treas. Reg. § 1.1092(b)-3T, other than the statute of limitations under section 6511.

Therefore, because the petitioner's [redacted] tax year is still open, he may still amend his return to take advantage of Treas. Reg. § 1.1092(b)-3T. For discussions on the permissibility of making an election or amending a return after filing a petition with the Tax Court, see Fischer Industries, Inc. v. Commissioner, 87 T.C. 116 (1986), aff'd per curiam, 88-1 U.S.T.C. para. 9240 (6th Cir.); Royster v. Commissioner, T.C. Memo. 1985-258; Hosking v. Commissioner, 62 T.C. 635 (1974), and cases cited therein.

Although the holdings in some of the cases cited above turned on whether the taxpayer was acting in good faith in not making an election on his original return, the peculiar circumstances of the instant case lead us to conclude that the issue of the petitioner's good faith would not be a significant enough factor to persuade the Court to hold in the Commissioner's favor. In all the cases cited above, there was an affirmative requirement to make an election. In the instant case, the regulation is ambiguous to the point that there is no requirement to make an election. Furthermore, the fact that the regulations under the amended section 1092(b) were not published until early 1985 and the Code was not amended until July 1984, makes it difficult for the Commissioner to require strict compliance for the [redacted] tax year.

It should also be noted that the examiners in this case have represented to us that, upon their analysis of the computer program by which the petitioner identified the mixed straddles, it is their opinion that he used a "reasonable and consistent economic basis" for identifying the straddles.

RECOMMENDATION

For the reasons stated above, we recommend conceding this issue. This is the same recommendation we gave Mr. Ferrick on May 19, 1989. It should also be noted that Joel Helke, CC:TL:TS, David Brandon, CC:FI&P, and Dan Breen, CC:FI&P concur in our recommendation.

If you have any questions, please call Lawrence Mannix at FTS 566-3470.

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